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Committee on Education and the Workforce
U.S. House of Representatives**

Hearing on:

**Strengthening Pension Security:
Examining the Health and Future of Defined Benefit
Pension Plans**

Testimony Presented By:

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The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

Chairman Johnson, Ranking Member Andrews, and distinguished committee members, thank you for inviting me to testify on “Strengthening Pension Security: Examining the Health and Future of Defined Benefit Pension Plans.” My name is Ron Gebhardtsbauer, and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the public policy organization for actuaries of all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis.

My written statement will focus on the three important issues for this hearing, namely:

- The advantages of pension plans, both defined benefit (DB) and defined contribution (DC);
- Reasons why complex, contradictory, and out-of-date laws hurt employer-sponsored plans and reduce the number of workers covered by DB plans; and
- Suggestions to strengthen the voluntary pension system and retirement security of all Americans and level the playing field between DB and DC plans.

Advantages of DB and DC Pension Plans

Pension plans have advantages for employers, employees, and the nation.

- **Employers** provide pension plans not only for altruistic reasons; they have sound business reasons to provide them. For example, they help employers maintain their workforce. In addition, employers contribute to pension plans because they are tax efficient (\$1,000 contributed to a pension plan will provide a larger pension than \$1,000 saved outside the pension plan), and because they can satisfy employee demands.
- **Employees** want an employer pension plan because it improves their chance for a secure retirement. In fact, according to public opinion research, including the Academy’s, Americans most preferred saving through employers over doing it themselves or through the government.
- **Nation:** Pension plans are good for the nation, because they provide a large source of efficiently invested assets in our economy and reduce poverty among older Americans. Private pension plans are a necessary complement to government programs like Social Security.

DB plans have their own distinct advantages and disadvantages. Some people prefer DB plans, some prefer DC plans, and many like both. For example, while younger employees understand and value the cash nature of DC plans, many older employees and retirees appreciate that cash does not guarantee retirement security, as does a stable lifetime pension. In addition, when the stock market was performing well in the 1990s, many workers preferred DC plans. Now that the stock market has fallen dramatically, many workers are asking someone else to handle their savings and would prefer

employers to take care of this concern. Thus, there are advantages to having both types of plans, and many large employers do just that - they have a DB plan and a 401(k). Some special advantages of DB plans are:

- **For employees**, DB plans provide a secure, stable income for life (while DC plans do not have to provide lifetime incomes). Employees won't have to worry about risks, such as a bear market when they want to retire or after they retire, or outliving their money.
- **For employers**, DB plans can provide contribution flexibility and are better at keeping a stable workforce (e.g., employees with DC plans are more likely to retire early when the stock market does well). They are also professionally managed and achieve similar or higher returns with less risk than a typical employee-directed account (per Table E24 of the 1998 DOL Form 5500 abstract).
- **For the nation**, DB plans help reduce our dependence on social programs, such as Social Security, Medicare, Medicaid, and SSI (Supplemental Security Income) and reduce poverty rates at older ages more effectively than defined contribution plans.¹

Problems with Pension Laws and Regulations

With all these advantages of pension plans, one would think that government policy would encourage employers to have pension plans, and be neutral (at the very least) if an employer wanted a DB plan. In the past that was true. However, gradually through time, pension rules have become incredibly complex, costly, contradictory, and out-of-date, and have come to favor DC plans. This has caused a movement to DC plans and benefits payable in a lump sum, which means that fewer people will have pensions payable for the rest of their lives. This is a concern for public policy, since that can mean increased poverty levels at older ages.

We suggest this is the primary reason for the decline in DB plans. In 1975, just after ERISA was signed into law, 40 percent of the labor force participated in a DB plan, and 16 percent participated in a DC plan (see Chart I). Today, however, the reverse is true: only 21 percent participate in a DB plan, while 46 percent participate in a DC plan.² As Chart I shows, almost anyone who participates in a pension plan is in a DC plan. Sometimes it is in addition to a DB plan.

Analysts have attributed the movement from DB to DC plans to: (1) larger DC plan benefits for young, mobile employees; (2) employers attracting young employees with larger DC benefits upfront; and (3) DB benefits being more difficult to understand than DC benefits.

¹ Additional advantages can be found at http://www.actuary.org/pdf/pension/testimony_20june02.pdf

² The 2000 Form 5500 data are not available yet, because pension plans file about 9 months after the end of the plan year, which could be September 2002 for plans with plan years starting in December of 2000.

But I do not think that they have pinpointed the reason correctly, because a DB plan can look exactly like a DC plan to the participants. If the employer and employees wanted a DC plan, with employees being able to allocate their funds, they could simply change the DB plan formula to match the DC plan they wanted. There are plans in the U.S. that already do this. This approach would be much easier than having to terminate the DB plan and start up a DC plan from scratch. In addition, with the DB plan, the employer would keep the design, investment, and contribution flexibility. So, there must be another reason.

I suggest that the biggest reason for the decline in DB plans is that the playing field is not level for DB plans in the private sector. DC plans can have certain provisions, like pre-tax employee contributions and matches that private sector DB plans cannot have. As evidence, I note that Canadian employers and state and local governments in the U.S. have a much more level playing field for DB plans (for example, they have pre-tax contributions), and all three have a much higher percentage of DB plans than in the U.S. private sector.³

The other primary reason is that pension laws and regulations for private sector employers in the U.S. are much more costly and onerous for DB plans (than DC plans). In fact, some pension professionals consider the regulations draconian. A study by the American Academy of Actuaries in 1993⁴ showed that increased government regulation was the major factor in 44 percent of DB plan terminations in the late 1980s.

As further evidence, I note that there has also been a very large decline in DC plans that do not have a 401(k) arrangement. DOL Form 5500 abstracts show that of the 46 percent of the labor force participating in DC plans; 3/4ths of that number are in 401(k) arrangements. When you subtract out the 401(k) arrangements, you find that the remaining DC plans trail behind even DB plans. In fact, due to EGTRRA raising the contribution limits for 401(k)s,⁵ the 12 percent participating in “other DC plans” may practically disappear, because money purchase plans no longer have the advantage of larger deductible contributions. In fact, the competition is not between DB and DC plans. It is between 401(k) arrangements and all other plans, and 401(k)s are far ahead.

Examples of the complex, contradictory, and out-of-date rules are:

- (1) **Complex, Costly Rules:** One measure of complexity is the amount of administrative costs. The costs of administering a DC plan have doubled as a percentage of payroll since 1981 and tripled for DB plans (based on a study by the Hay Group).⁶ In addition, the study suggested that pension rules made DB plans more expensive to

³ See Professor Rob Brown’s paper discussing why a decline in DB plans did not happen in Canada in the July 2001 issue of the North American Actuarial Journal (NAAJ), and discussions in the April 2002 NAAJ.

⁴ *The Impact of Government Regulation on Defined Benefit Pension Plan Terminations*, a Special Report by the American Academy of Actuaries (March 1993).

⁵ EGTRRA, the Economic Growth, Tax Relief and Reconciliation Act of 2001.

⁶ *Retirement Income Plan Administrative Expenses 1981 through 1996*, presented to the Pension Research Council (May 1996)

administer than DC plans.⁷ It did not use to be that way. In 1981 the administrative costs of a 10,000-person DB plan were less than the costs of a similar-sized DC plan, but by 1996 the DB costs had grown dramatically to almost 50 percent more than the DC plan's administrative costs. At a company where both the employer and employees want a DB plan, costly pension laws and regulations strongly push employers to have a DC plan, so employers can end up not having what is best for their company.

(2) **Contradictory Rules:** There are many contradictory rules, caused by legitimate, competing interests. A few examples follow:

- (a) **Conflicts between the various discrimination rules:** Age discrimination rules can conflict with the rules prohibiting pension plans from favoring higher-paid and longer-service workers (because the older employees are generally the higher-paid and longer-service employees who cannot be favored).
- (b) **Conflicts between interpretation of lump sum rules and age discrimination rules:** An employer might want to improve interest credits in a cash balance plan for their employees, but some people interpret lump sum rules to say that the plan must pay a lump sum that would violate age discrimination rules. That interpretation keeps some plan sponsors from providing favorable investment returns to employees.
- (c) **Conflicts between adequate funding and the need for government revenue (and the reversion excise tax):** Pension funding rules should allow some flexibility between the minimum and maximum contribution. However, sometimes the minimum funding rules require larger contributions than the maximum deductible rules. Fortunately, the minimum is always deductible, but it doesn't allow any flexibility. This points out the tension between revenue loss and benefit security. In addition, the maximum deductible rules inhibit contributions when a company is healthy and able to contribute more, and the minimum funding rules can force unusually large contributions at the most difficult times (e.g., today). In addition, rules taxing reversions at 50 percent (in addition to the 35 percent income tax rate) discourage employers from creating surpluses in their plans, which would increase benefit security

(3) **Out-of-date Rules:** Static pension rules have not kept up with the dramatic changes in the economy and new designs in pension plans. Some problems with out-of-date rules are:

- (a) **Rules have not kept up with changes in economy:** The economy has changed dramatically over the past 5 years. Treasury rates fell much faster

⁷ For example, in the 1970s one valuation was needed every 3 years. Today, multiple valuations are needed each year for funding, PBGC disclosure, PBGC premiums, SFAS 87 purposes, etc.

than corporate bond rates. In 2000 and 2001, a pension plan that could buy annuities for all employees was labeled “underfunded” because the highest permissible discount rate was lower than interest rates used in pricing annuities. Funding rules, based on Treasury rates, dramatically increase minimum pension contributions, at a time when companies can least afford it. Fortunately, Congress fixed the rule for 2002 and 2003, but is having a difficult time deciding upon a permanent fix in a timely way for 2004 and thereafter.

- (b) **Rules have not kept up with new types of plans:** New types of DB pension plans, which address the concerns of mobile employees, have been in use for over 15 years, but there are few laws or regulations addressing them. For example, see the problems discussed in our issue brief on whipsaw.⁸
- (4) **Level Playing Field For DB Plans Lost:** DC plans are easier to understand, which may be why the rules for DC plans are more up-to-date than for DB plans. In particular, Congress created simple DC plans (Simple plans, 401(k)s, etc.) where the regulatory burden is greatly reduced. Unfortunately, this provides an inherent advantage for DC plans. Even if employers and employees want to have a DB plan, pension rules make that a difficult decision to make. In addition, private-sector DB plans can not have certain provisions that DC plans can have, which also discourages employers from having DB plans. Examples of these provisions are:
 - (a) **Pre-Tax Employee Contributions**, which governmental DB and private-sector DC plans can have),
 - (b) **Employer Matches of Employee Contributions:** Which 401(k)s and non-profit DB plans can have,
 - (c) **Phased Retirement**, which allows employees to partially retire, continue working part-time, and receive a partial pension (with early retirement subsidies, if any). DC plans can commence these pensions before the Normal Retirement Date, but not DB plans.

Fixing Pension Laws

The above problems make it difficult for employers to start up and maintain pension plans. As one can see from the above examples, pension laws in their totality need to be reviewed to create a comprehensive, sensible pension policy. The complex, contradictory, and out-of-date laws need to be fixed. In addition, laws governing DB plans need a level playing field to survive as attractive retirement programs.

In the following paragraphs, we provide some possible suggestions for resolving the complex, contradictory, and out-of-date rules discussed earlier.

⁸ “What’s Whipsaw? Why is it a Problem?” at http://www.actuary.org/pdf/pension/whipsaw_feb03.pdf

(1) Fix the discount rate for funding liabilities. The most urgent need is to fix the discount rate, which is currently based on 30-year Treasury rates. As noted earlier, current funding rules have dramatically increased minimum pension contributions at a time when employers can least afford them. Part of the problem is due to the discontinuance of the 30-year Treasury bond, and the unusually low rate for determining liabilities. The chart of discount rates at the end of this testimony shows that the maximum permissible rate was less than an annuity pricing rate in 2000 and 2001, and the rate would have been lower in 2002, if it were not for the temporary fix that Congress passed last year.

Employer and labor groups have both suggested using a high-quality corporate bond rate. Pension liabilities for financial statements are generally discounted using current high-quality corporate bond rates, due to the requirements of Financial Accounting Standard 87 (FAS 87 paragraph 44) and statements by the Securities and Exchange Commission (SEC). Two bills have been proposed that would use this rate, one of which would reduce the top of the permissible range from 105 percent down to 100 percent. The Treasury Department has also suggested using a high-quality corporate bond rate, so the various parties are not far apart.

However, Treasury also suggested that the corporate discount rate be a yield curve (instead of the average long term rate) to reflect the duration of a pension plan's liabilities. This has delayed the enactment of a permanent fix. Since a yield curve has a relatively small effect on liabilities – a study shows that liabilities would only be increased by 2 to 3 percent on average – the additional complexity is not warranted. In addition, best actuarial practices would call for using more precise, individually reasonable mortality tables if we are using more precise interest measurements. Ironically, using these mortality tables would in many cases completely offset the effects of the yield curve, since the types of plans that would experience the highest increase when introducing a yield curve would generally be the types of plan that would experience the largest decreases if we were permitted to use individually reasonable mortality tables. The use of a yield curve would be expensive to implement for small plans, and would complicate other areas of pension law which are logically tied to this rate (e.g., lump sum determinations, returns on employee contributions, cash balance interest credits). Thus, Congress might want to delay the requirement to use a yield curve until it has been thoroughly discussed by all parties, preferably in connection with a complete overhaul and simplification of the funding rules.

Additional details on fixing the discount rate and strengthening the funding rules for underfunded plans can be found in our paper on this subject, entitled “Alternatives to the 30-year Treasury rate.”⁹ Another issue that policymakers need to consider whenever the funding rules are modified is the effect of the changes on the PBGC. Increasing the discount rate in accordance with Congress's earlier intentions (something close to a corporate bond rate or annuity pricing rate) may help the PBGC indirectly if it means that employers are more likely to be able to afford their pension plans for a few more years (hopefully, until the economy recovers). This could mean that fewer plans will need to

⁹ It can be found at our website at http://www.actuary.org/pdf/pension/rate_17july02.pdf.

be trusted by the PBGC and more defined benefit plans will be around to pay premiums to the PBGC. By fixing the discount rate, Congress signals to employers its intention to keep defined benefit plans as a viable option for employer retirement programs. However, that statement comes with a caveat. Since increasing the interest rate reduces minimum contributions, we need to review the funding and premium rules, particularly if PBGC has further major losses over the next couple of years in this current economic downturn.¹⁰

(2) Overhaul the funding rules for DB plans. The current funding rules are incredibly complex and need to be overhauled, and for this purpose we created a task force to research this issue. The task force is also addressing the conflicts between minimum funding rules (which promote pension security and help the PBGC) and maximum deductibility rules (which are for revenue concerns).

The funding rules need to be simplified. For example, there are 11 different amortization periods/rules¹¹ for paying off liabilities in the funding rules in IRC §412(b) and two more in §412(l), while the accounting standards only have 3 rules (working lifetime, retiree lifetime, and period benefited for frequent amendments). In addition, these funding rules cause problems. They allow employers to improve retiree benefits (which are payable over 10 to 20 years) and pay for the improvement over 30 years, which hurts a pension plan's funding levels. On the other hand, underfunded plans must pay off their deficit in 3 to 7 years, so contributions can be very volatile when plans go from 30-year funding rules to 7-year funding rules.¹² In fact, the volatility was even more dramatic for plans that were prohibited from making deductible contributions in the late 1990s, and now must fund their deficits over 7 years (see the attached chart labeled "Current Funding Rules"). This problem did not happen when the rules were implemented. In the 1980s, current interest rates were much higher, so the full funding limit was much higher than current liability, and the funding rules allowed plans to create surplus margins in their plans. Today, however, the full funding limit (FFL) can be less than the unfunded current liability for some plans (e.g., hourly plans which cannot project benefits). This makes it difficult for them to create a surplus to get them through difficult times. Employers may not have wanted to increase surpluses in the past due to the high reversion tax, but recent experience has taught them the value of having a surplus in their plan. (See the last chart on allowing contributions in good years.) Here are some specific suggestions:

(a) Faster Amortization: The funding rules could be simplified, strengthened, and made less volatile with one change – reduce the number of amortization periods. The funding rules in §412(b) could use something less than the 20 and 30-year periods, but more than the 5-year period for experience gains and losses (which cause volatility). Accounting rules already require a shorter period for expensing, so plans may be ready for this change. Unfunded retiree liabilities and frequent benefit improvements could be amortized faster if desired, which would

¹⁰ Also see our April 30, 2003 testimony on this subject before the Ways & Means Subcommittee on Select Revenue Measures at http://www.actuary.org/pdf/pension/funding_testimony_043003.pdf.

¹¹ If multiemployer rules are counted separately.

¹² In addition, the liabilities are calculated much more conservatively.

be a simpler and better way to handle mature plans than using yield curves. This rule would also be closer to the rules for underfunded plans, but some additional smoothing may be needed to phase into them. Faster amortization would also address the concerns that PBGC has with large credit balances eliminating deficit reduction contributions.

(b) Greater Deductions in Good Years: In addition, to provide more flexibility between the minimum and maximum rules, a plan should always be allowed to deduct the normal cost (unless the plan is very overfunded), or enough to avoid a variable premium to the PBGC. One way to do this would be to allow deductions up to, for example, 130 percent of current liabilities, or the full funding limit if greater. Alternatively, the full funding limit could use end of year assets (which would enable employers to make contributions to avoid a hit to equity that SFAS 87 might impose).

Contributions are not deductible (and are subject to a 10 percent excise tax) when plan assets exceed maximum tax-deductible limits. Congress has addressed this problem to some extent by allowing a deduction for the full amount of the unfunded current liability – but even this has not been enough to prevent the current shortfall in pension funding experienced by many employers.

When current interest rates are low,¹³ the deductible limit provides little or no margin for adverse fluctuations in assets or liabilities and, in many cases, as discussed later in this testimony, does not even include liabilities for benefits the plan is committed to provide. Over the past three years, we have seen a significant decline in the funded status of plans – both because the market value of plan investments have fallen, and because liabilities have increased due to lower discount rates.

Thus, we suggest policymakers consider allowing sponsors to deduct contributions until the plan is funded to some higher amount such as 130 percent of current liability (without smoothing).¹⁴ This 30 percent margin would have covered all but two periods in the last 100 years: the depression years (dramatic decreases in stock prices) and the past two years (dramatic decreases in stock prices and decreases in interest rates). If policymakers want the margin to cover an event like this recent period, then 165 percent would be needed.¹⁵ We

¹³ When current interest rates were higher, the full funding limit provided a more generous margin above termination liability. Today, however, current liability interest rates are much lower. If current liability interest rates are below valuation rates (which is possible if they equal 105 percent of a current Treasury rate), the full funding limit of an hourly plan (or even some salaried plans with mostly retirees) can be less than termination liability (because they can not project benefit improvements), so they have no margin for adverse fluctuations. And these are the very plans that are more likely to be underfunded now.

¹⁴ This can be accomplished by replacing the words “current liability” with the words “130 percent of current liability” in §§404(a)(1)(D) and 404(a)(7)(A), and defining it using the current interest rates, not smoothed ones.

¹⁵ What should this margin be? A frozen plan funded to 100 percent of termination liability (TL) on 1/2000 could be close to 50 percent funded on 1/2003. The calculations are as follows: \$100 of assets in 2000

recognize the need to balance concerns about pension security with concerns about the revenue impact; to address this perhaps a lower percentage could be used or the use of 130 percent could be restricted (to plans covered under Title IV of ERISA, for example). Other ways to improve funding are:

- Allow full projection of future benefits. For example, projecting future increases in benefit and compensation limits would be very helpful in improving funding levels for plans where many participants have large benefits (such as pilot plans).
- Allow hourly plans to amortize benefit improvements faster or fund beyond current liability. Otherwise these plans are always funding benefit increases in arrears, and are always underfunded.
- Recognize lump sums in current liability. Otherwise, plans cannot fund to the benefits that they may actually have to pay.

These ideas and others will be in a paper that we are writing on improving the maximum deductible rules.

(c) Asset Withdrawals: Another conflict in the funding rules is caused by the excise tax on reversions. If employers were to contribute a surplus to the plan, and then asset returns exceeded expectations, their pension plans could have more money in them than they would ever need. However, it is difficult for employers to use those surplus funds, unless they terminate the plan (which hurts employees), and pay about 90 percent of the surplus in taxes, which makes it uneconomical. Reversion taxes were implemented in the 1980s to stop corporate raiders from taking the pension surpluses, and some groups still oppose reversions. However, some restrictions could be placed on reversions that might satisfy both parties and avoid the problems of the 1980s, such as:

- Only allow a withdrawal if the assets are unusually high, such as in excess of 150 percent of current liability (or the FFL if greater).
- Set the excise tax so that it offsets the tax advantage the funds received while in the plan. An excise tax under 15 percent could be justified now, due to recent changes lowering tax rates on dividends and capital gains.
- Allow withdrawals only for other employee benefits.
- Require consent by the collective bargaining unit, if the plan is bargained.

(3) Revise Congress' budget rules to reflect future tax revenue received on pensions.

Changing the funding rules may cost the government revenue. Whenever Congress tries to improve retirement security by strengthening pension funding or by increasing pension coverage to the part of the working force without pensions, current budget rules show the loss in revenue today for the higher contributions and the larger assets sheltered. But this misses the point that pensions are tax-deferred, not tax exempt. Thus, tax revenue will increase beyond the budget window and pay back the revenue loss due to higher contributions

would be \$82 1/2003 (assuming a typical 70 percent allocation to stocks and 30 percent to shorter bonds). In addition, due to interest rates dropping by almost 200 basis points since 2000, \$100 in liabilities could be over \$150 today, so the funding ratio could be about 50 percent now.

If the budget rules could reflect the additional tax revenue in the future, it would be easier to pass solutions to the pension funding and coverage problems. The budget rules already reflect income beyond the 10th year under the Credit Reform Act of 1990 for government loans by offsetting the payments received in the out years for housing loans, school loans, rural electrification loans, the Disaster Loan fund, loans for rural development, the Business Loan Investment Fund, mortgage guarantees, international aid, the Export-Import Bank, foreign military sales, and the Overseas Private Investment Corporation. The reason behind passing the Credit Reform Act was similar: it helped Congress make the best financial decision when deciding whether to provide loans or loan guarantees. This rule change could help Congress make better changes to pension law.

(4) Clarify the laws for hybrid plans. Hybrid plans (e.g., cash balance and pension equity plans) have been around for almost two decades, but the laws and regulations have not been updated to handle these new kinds of retirement plans. Consequently, new rules are being created through court decisions, which try to adapt the old rules to the new plans. Since there has been no clear guidance from Congress to the courts, some employers are falling into traps that did not exist when they set up their plans. A preferred way to handle this problem would be to legislate a solution that applies prospectively. Employers want to follow the rules; they just need to know what they are.

When age discrimination rules were created, they provided different rules for DB and DC plans. Hybrid plans were not on the radar screen. Since they are DB plans that look somewhat like DC plans, it makes sense in certain situations to apply DC rules to them. Without this accommodation, some people have suggested that age discrimination rules prohibit a cash balance plan with the same pay credits for everyone, even if such a plan exactly mimicked a legal DC plan (including investment returns). That does not seem to make good policy sense. On the other hand, a solution to treat hybrid plans as DC plans can create cliffs between traditional DB plans and hybrid DB plans, so another possible solution might be to have one set of rules that apply everywhere. This could make sense, because it can be difficult to distinguish between DB, DC, and hybrid plans. However, cash balance plans that replace a traditional DB plan, may desire to maintain some characteristics from the DB plan, such as subsidized early retirement benefits, so in certain situations, they will need DB rules.

(5) DB-K and Leveling the Playing Field: One way that would greatly level the playing field would be to simply allow DB plans to have 401(k) features.¹⁶ This “DB-K” plan could have many of the advantages of DB and DC plans in one plan. For example, part of the pension plan could look like a 401(k) to employees (with pre-tax employee contributions and employer matches) but also still allow employers funding and design

¹⁶ Congress could revise IRC Section 401(k) to allow 401(k) features in DB plans. For example, add the words “defined benefit plan” to the first sentences of IRC Sections 401(k)(1), 401(k)(2), 401(k)(2)(B)(i)(III) and (IV), and 401(m)(1), and add a sentence to 401(k) that Treasury will specify in regulations how the words “contributions” and “deferrals” can include pay credits to DB plans. Other sections of the law may also need revisions.

flexibility of a DB plan. Employers could promise investment returns based on corporate bond rates and/or stock returns. The assets of the 401(k) portion could be held separately from the DB assets or merged with them. Our ideas contemplate one trust fund where all assets are available to pay all benefits.¹⁷ However, these ideas are compatible with other DB-K proposals that contemplate a separate pool of assets. Here are some DC features that DB plans should have:

- Pre-tax employee contributions or deferrals (government DB plans have them through Section 414(h) pickup rules);
- Matches (hospitals and other non-profits can have matches in their DB plans);¹⁸
- Additional matches from the government for low-income employees (as in DC plans);¹⁹
- A small-business tax credit for starting new plans (just like the one for new DC plans);²⁰
- Better returns than Treasury rates,²¹ including returns based on stock and bond indexes;
- Safe harbors (using benefits or pay-related credits in cash balance plans, and/or cash matches) which could provide some regulatory relief;²²
- Immediate participation at hire without affecting ADP and ACP rules;²³
- Automatic elections;
- Phased retirement at age 59½, which a 401(k) can have pursuant to IRC 401(k)(2)(B);²⁴
- DC accrual rules and the ability to test greater of benefit formulas separately.

The issue on phased retirement is a major one. Please see our paper on this subject at http://www.actuary.org/pdf/pension/irs_30dec02.pdf.

DB-K Plus plans could have features from DB plans, in which policy-makers have expressed a renewed interest, such as:

- Automatic qualified joint and survivor annuities as the default option;
- Reduced administrative expenses;
- Funding, investment,²⁵ and design²⁶ flexibility;

¹⁷ A complete discussion of DB-K can be found at http://www.actuary.org/pdf/pension/dbk_jan03.pdf.

¹⁸ Revise IRC 401(k)(4)(A) to include DB plans.

¹⁹ Revise IRC 25B to include pay-related credits in DB plans.

²⁰ Revise IRC 45E to include DB plans

²¹ Revise IRC 417(e) to allow account-based DB plans with market-related returns to pay just the account at termination of employment. Another way to do this is to define the account as the accrued benefit.

²² Include DB plans in the IRC 401(k)(12)(C) safe harbor, with the same rules for account-based DB plans, and allow Treasury to define the equivalent accrual for traditional DB plans (e.g., a ¾ percent pension accrual could be equivalent to the 3 percent rule in the 401(k) safe harbor).

²³ Include DB plans in IRC 401(k)(3)(F).

²⁴ We suggest allowing phased retirement at age 55 or after 30 years of service.

²⁵ For example, it is difficult for a DC plan to invest in real estate and other hard-to-value assets. The move from DB plans to 401(k)s hurts the industries thus affected.

²⁶ For example: early retirement windows, good benefits for all employees through an account-based formula at young ages and a traditional DB pension formula at older ages (using a greater-of-formula), portability credits (cash or benefits) from prior jobs or prior service, COLA purchases from the account side, transfers from account side to pension side at benefit commencement to buy a level pension.

- Guarantees (if the employer so desires, possibly for a charge); and
- PBGC guarantees.

Other rules will be needed to ensure that these plans are viable for employers and employees, such as:

- Separately applied maximums to DB and DC parts;²⁷
- Ability to revise investment credits/guarantees in the future;
- Ability to move benefits from the DB to the DC side and vice-versa;
- Rules on conversions from current plans; and
- Simple funding rules appropriate for account-based plans.

Other ways to level the playing field can be found in my in my testimony before the U.S. Department of Labor's ERISA Advisory Board (available on the Academy's website at http://www.actuary.org/pdf/pension/ERISA_071701.pdf).

(6) Allow employers to raise the pension plan's normal retirement age. Currently, a pension plan cannot raise its normal retirement age above 65. Congress has already raised the retirement age for Social Security. It is inconsistent with Congress' pro-work policy for older Americans for the retirement age for pension plans to be kept at age 65. Allowing pension plans to use the same normal retirement age as Social Security would make sense.

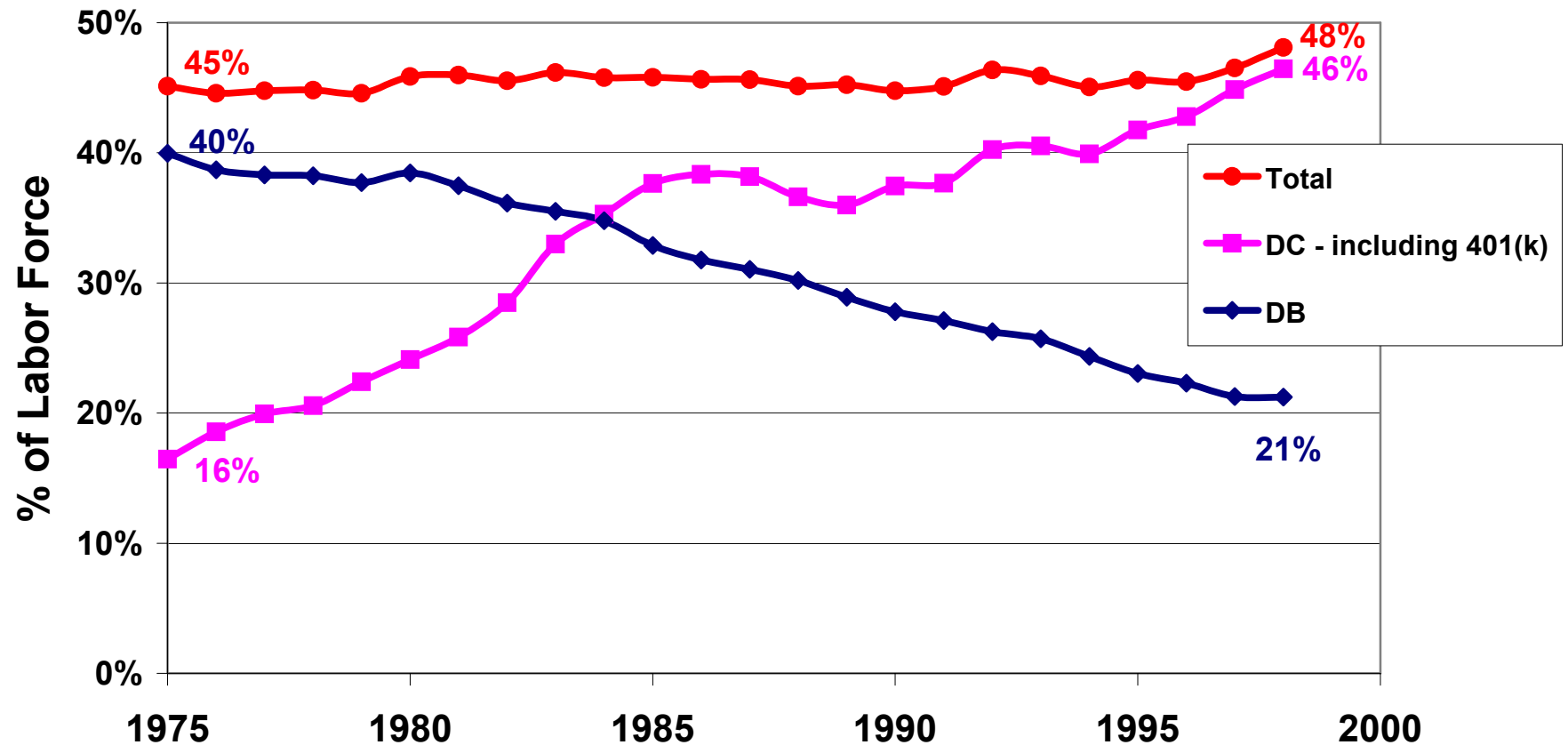
Conclusion

DB plans were once the most common way of providing retirement security to America's workers. However, due to the non-level playing field created by pension laws, many employers have switched to 401(k) plans, which do not provide the same level of retirement security as traditional DB plans. One way to level the playing field is to allow DB plans the same flexibility as 401(k)s. Other ideas (such as fixing the discount rates and simplifying the minimum funding rules²⁸) are discussed in my testimony, and I would be glad to analyze the effects of any proposals you wish to consider. Thank you for the opportunity to share my views today.

²⁷ Clarify IRC 414(k)(2) so that employers could designate whether a pay credit is tested as DB or DC for Section 415 purposes.

²⁸ Also, see the suggestions in my testimony before the U.S. Department of Labor's ERISA Advisory Board (available on the Academy's web site at http://www.actuary.org/pdf/pension/ERISA_071701.pdf).

Chart I - Participation Rates in Pension Plans (by type)

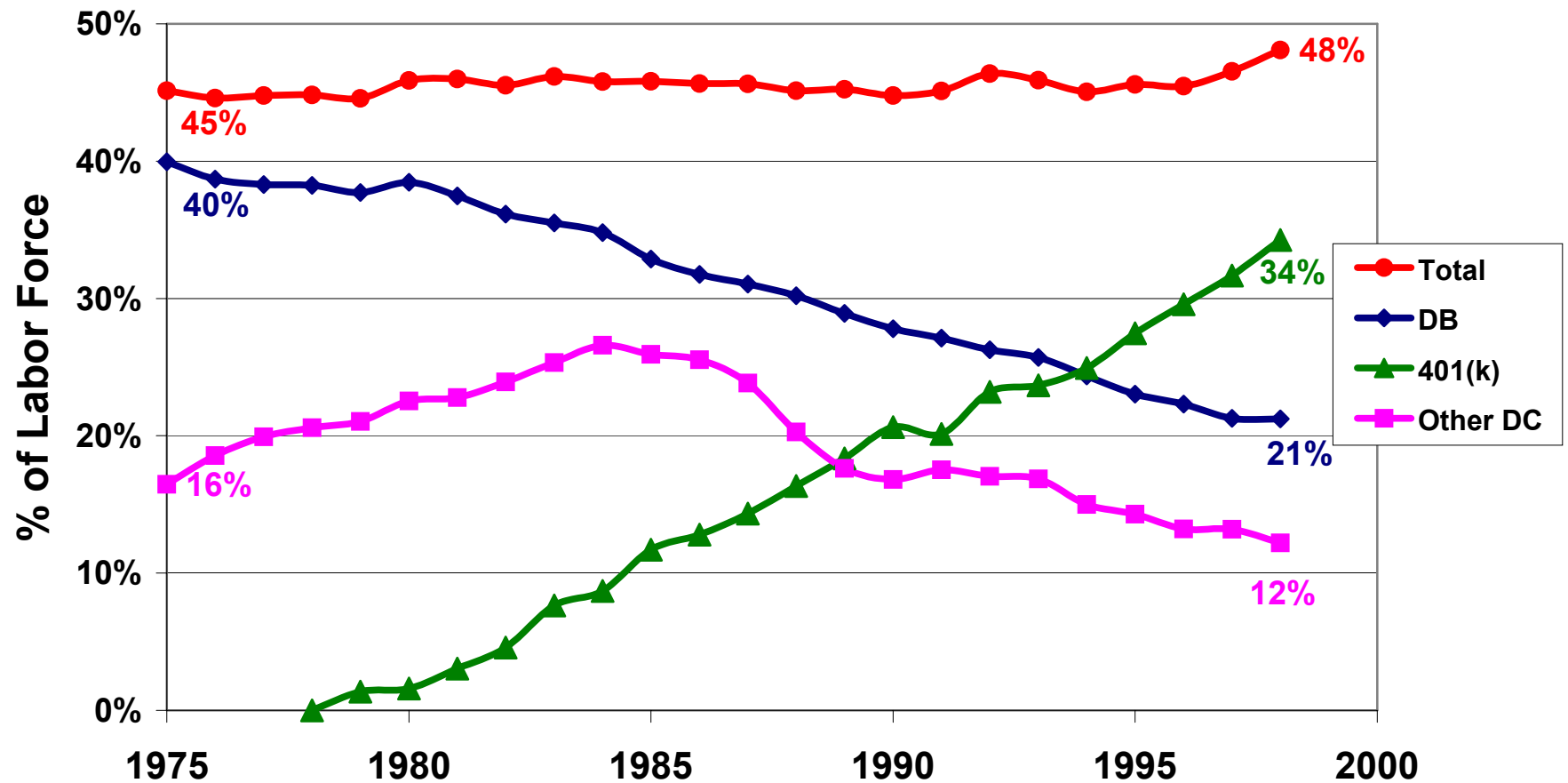


About half of the labor force participates in a pension plan, and almost all of them are in a DC-type plan (for some it's on top of their DB plan). Note: Don't add % in DC and DB, because some workers are in both.

Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers.

Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4 & E8.

Chart II - Participation Rates in Pension Plans (by type)

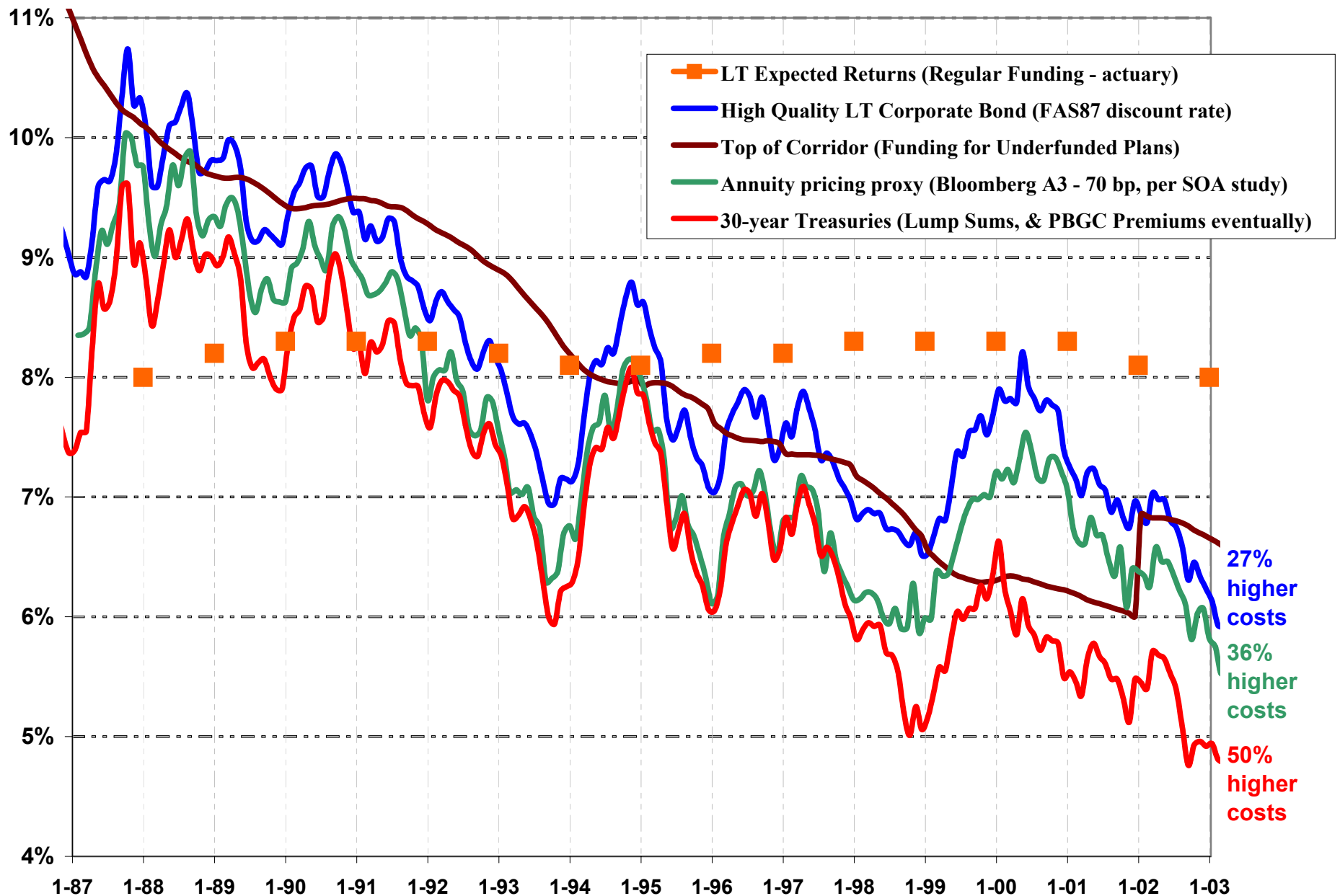


It's not a battle between DB and DC. It's a battle between 401(k) and the others, and 401(k) is far ahead.

Why? Favorable laws for 401(k), especially pre-tax contributions and match.

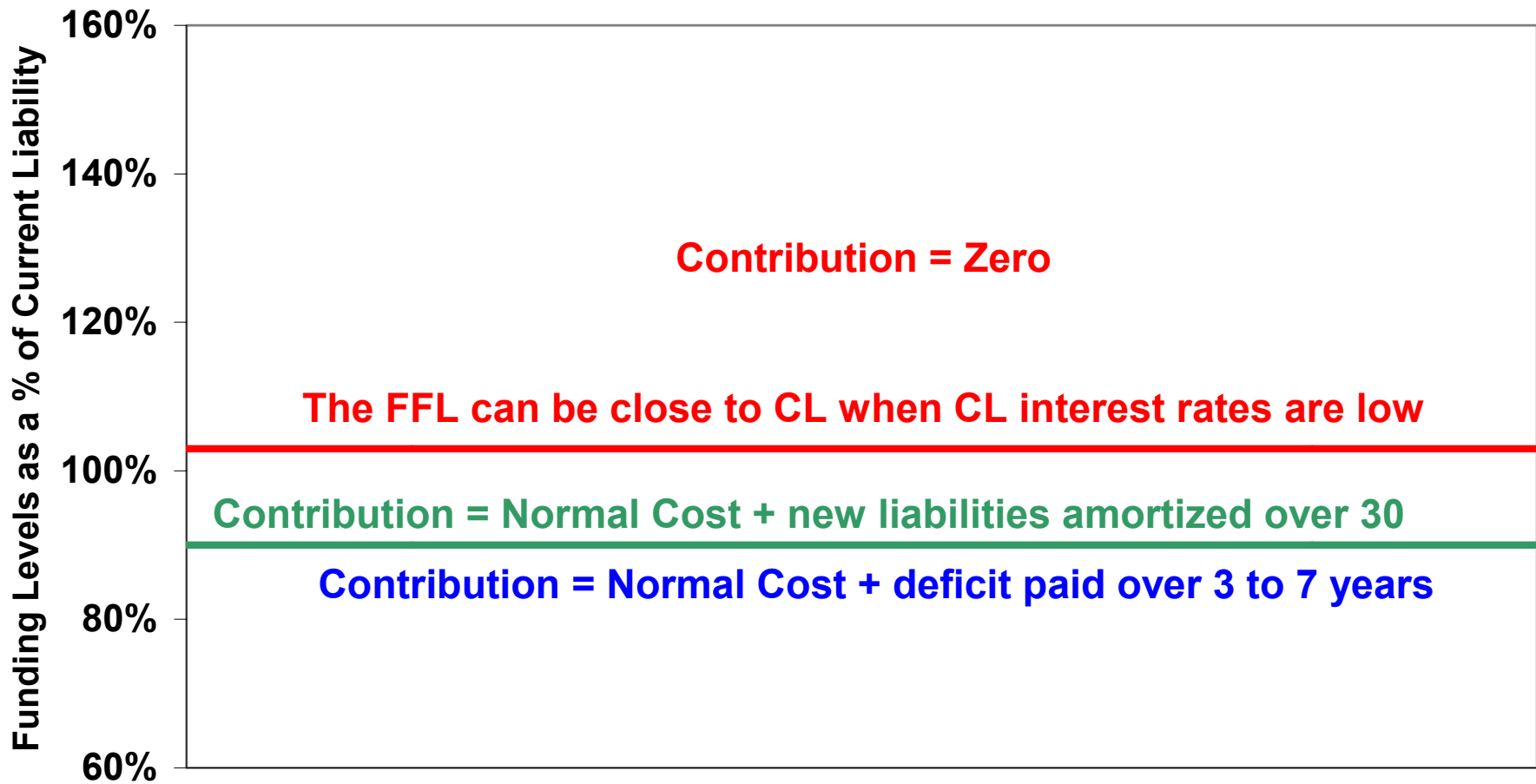
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4, E8, & E23.

Choices for Discount Rates



Choices for discount rates in paper by American Academy of Actuaries: Long Term Expected returns, HQ Corporate Bond returns, Annuity Prices, and Treasury rates. They produce the costs indicated (relative to LT Expected Returns used for funding), assuming an average pension plan (with duration around 12). The expected returns are from Watson Wyatt surveys.

Current Contribution Rules



For many plans, the original ERISA contribution rules (normal cost + new benefit liabilities amortized over 30 years) now only apply in a very small range (plans with current liability funding levels between 90% and 100%). The new deficit reduction contribution rule applies when the funding ratio is under 90% (unless the 2 consecutive prior years or 2nd and 3rd prior years were above 90%) and always applies when the funding ratio is under 80%. It is like converting a 30-year mortgage to a 5-year mortgage (although the bank does not have to do that because it has security for the loan).